Building a Competitive Municipal Credit Market

Czech Republic

Background

Decentralization in the Czech Republic has transferred service responsibilities to local governments along with shared tax revenues. At the same time, the national government has cut back on targeted subsidies for local investment projects. To sustain their capital spending, local authorities had to find a way to access the credit market. One possibility was to create a single Municipal Credit Facility, under government direction, that would provide loans to local authorities. This approach, however, ran counter to the Czechs' desire to introduce competition into the financial sector and to lessen dependence on central institutions in allocating capital. The state decided to encourage commercial banks to enter the municipal credit market in a free market approach to municipal finance.

Innovation

Instead of a single Municipal Credit Facility that would make loans directly to local governments, the government created a financial intermediary—the Municipal Infrastructure Finance Company (MUFIS)—which raises capital externally, then channels the capital to commercial banks for on-lending to municipalities. Key to this innovation is the responsibility given to private lenders. Commercial banks perform all financial and project analysis for the municipal loans they make, and they assume all credit risk. The municipalities set their investment priorities and approached private entities for financing; MUFIS's role is to supply long-term capital, at market rates of interest, to help finance bank lending for local infrastructure projects.

MUFIS was designed to encourage the entry of new banks into the municipal credit market, so as to build sustainable competition. All banks meeting capital adequacy and safety standards were allowed to participate in the on-lending system. The Czech government concluded that the most effective way to reduce municipal credit costs over the long term was to introduce numerous banks to the municipal sector and to build up a track record demonstrating that municipal lending was a safe, productive activity for the banking sector.

Results

MUFIS has borrowed $20 million from the U.S. private capital market. Four Czech banks have borrowed funds from MUFIS and have lent these funds to 26 municipalities. MUFIS has established a reputation as a fast-acting, non-bureaucratic institution. On average, municipalities have been able to receive funds only 17 days after a loan application is approved by a commercial bank.

A strong base of competition has been established in the municipal credit market: all of the large commercial banks in the Czech Republic now compete for municipal lending. There have been no defaults on any of the more than 1,200 municipal loans. Under the pressures of competition, loan periods have been extended—the majority are now over four years on loans financed by banks' own resources, and up to 15 years on funds provided by MUFIS—while interest rates have fallen. The successful track record of bank lending to municipal governments has caused other financial institutions to enter the municipal credit market. A municipal bond market has emerged, serving larger cities in the Czech Republic.

In the aggregate, commercial lending has been able to substitute for government subsidies in financing local government investment. The share of investment in local government budgets has risen each year since 1993, despite reductions in central government capital subsidies. In 1995, 38.4% of local government budgets were spent on capital investment.

Summary

To sustain capital spending by local governments, the Czech national government decided to encourage commercial banks to enter the municipal credit market by creating a financial intermediary—MUFIS. Four Czech banks have borrowed funds from MUFIS and have lent these funds to 26 municipalities. The private municipal credit market has expanded, and a municipal bond market has emerged.

For more information contact:

Vera Kamenickova, Co-Chairman of the Supervisory Board, MUFIS
Tel. 42-2-2454-225
Fax 42-2-2454-212

Ladislav Maska, Co-Chairman of the Supervisory Board, MUFIS

Josef Vanik, Chairman of the Executive Board, MUFIS

Tel. 42-2-2100-9454
42-2-2100-9470
Fax 422-2-260-273
422-2-260-621